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Financial Markets

Irving Trust

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Economic Research & Planning Division

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On July 9, the FOMC made a significant amplification of the directive issued to the manager of the Open Market Desk: "In assessing the behavior of M-1A and M-1B, it was also understood that the rate of growth of M2 would be taken into account." Since the FOMC recognized that a disproportionate amount of the recent strength in M2 was attributable to growth in the shares of money market mutual funds, this increased their importance.

This change of emphasis potentially could be of major importance to the future conduct of monetary policy. To see why, it is instructive to recall how the controversy over redefinitions of the monetary aggregates arose. Early in the 1970s, the Federal Reserve began to embrace monetary-aggregates targeting; and by the middle of the decade, numerical money growth objectives were firmly entrenched in the policy process. Unfortunately, at about the same time, the forecasting performance of the key statistical money demand relationship began a steady deterioration, racking up a massive cumulative overprediction. This was the "missing money" that spurred interest in redefining the money aggregates.

Thus the point of departure for the redefinitions was the need to find a money measure that would preserve the stability displayed by the money demand relationship prior to mid-1974. Unfortunately, as the staff of the Federal Reserve Board admitted earlier this year, the new narrow, or transactions-oriented, aggregates do little to solve the problem. The result is continuing instability in the statistical money demand relationship and thus increased uncertainty in the monetary targeting process. Chairman Volcker gave dramatic evidence of this fact when, in his July congressional testimony, he indicated the FOMC's willingness to tolerate a wide range of M1B growth rates in the second half of this year.

What accounts for the instability? A considerable amount of statistical and anecdotal evidence suggests that much of the "missing money" is in overnight RPs and money fund shares. Both of these instruments enable interest to be paid on transactions balances. The money funds are especially important, having grown from zero in early 1974 to over $80 billion recently. And most important, addition of overnight RPs and a portion of money fund shares to M1B produces an aggregate that makes the estimated money demand relationship track better.

So the FOMC may be doing well to assign more weight to M2. But the above analysis implies that money growth has been considerably stronger than is generally realized. At a minimum, the strong growth has unpleasant implications for the long-run pace of inflation and for the Fed's future policy stance.

William C. Melton

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Market Yields

	8/29/80	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	(Noon)		
Short-term loans to substantial depositors with highest credit rating	11.50%	11.25%	12.25%
Effective since	8/27/80		
Discount Rate at Federal Reserve Bank	10.00	10.00	10.50
Federal Funds	11.00	10.13	11.16
Repurchase Agreements	10.75	9.50	10.25
U.S. Treasury Issues			
Bills			
3 months	10.36	10.02	9.75
6 months	10.74	10.70	10.30
1 year	10.50	11.02	10.31
Coupons			
2 years	11.55	11.10	9.84
4 years	11.80	11.25	9.35
7 years	11.90	11.30	9.22
10 years	11.90	11.26	9.19
Long Bond	11.50	11.21	9.08
Negotiable Certificates of Deposit-Secondary Market			
1 month	11.05	10.30	11.10
3 months	11.60	10.75	11.35
6 months	12.00	11.00	11.55
1 year	12.20	11.50	11.10
Banker's Acceptances			
1 month	11.05	10.20	11.25
3 months	11.45	10.50	11.46
6 months	11.60	10.90	11.69
Eurodollar Deposits			
1 month	11.25	10.38	11.75
2 months	11.50	10.75	12.06
3 months	12.25	11.13	12.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.75	9.64	10.63
1 month	10.63	9.95	10.88
3 months	10.50	9.99	10.25
Bank Holding Companies			
1 month	10.25	9.45	10.80
Dealer Placed:			
3 months	10.50	10.25	11.00
New AA Corporate Utility Bond	13.13	12.75	9.80
Tax Exempt			
6 month Project Notes	6.60	6.40	5.30
1 year AAA Bond	5.75	5.90	NA
5 year AAA Bond	6.30	6.20	NA
20 year AAA Bond	8.20	8.20	6.00

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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